



*Improvements Have Been Made to
Educate Tax-Exempt Organizations and
Enforce the Prohibition Against Political
Activities, but Further Improvements
Are Possible*

June 18, 2008

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 18, 2008

MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT ENTITIES
DIVISION

FROM: *Michael R. Phillips*
Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Improvements Have Been Made to Educate
Tax-Exempt Organizations and Enforce the Prohibition Against
Political Activities, but Further Improvements Are Possible
(Audit # 200710036)

This report presents the results of our review of the Exempt Organizations (EO) function's process for reviewing alleged political campaign intervention by tax-exempt organizations. The overall objective of this review was to assess the effectiveness of the Tax Exempt and Government Entities (TE/GE) Division in addressing alleged political campaign intervention by Internal Revenue Code Section 501(c)(3)¹ organizations and to determine whether actions to date had detected potential repeated campaign intervention by previously identified organizations. This audit was requested by the former Internal Revenue Service (IRS) Commissioner and was conducted as part of the Treasury Inspector General for Tax Administration Office of Audit Fiscal Year 2008 Annual Audit Plan related to the Major Management Challenge of tax compliance initiatives.

Impact on the Taxpayer

The Political Activities Compliance Initiative (the Initiative) was implemented to educate tax-exempt organizations about the types of prohibited political activities and to notify organizations of the program implemented by the TE/GE Division to enforce this prohibition. The EO function increased its efforts to educate tax-exempt organizations about prohibited political activities and enhanced several internal processes. However, it could further improve its effectiveness by tracking the reasons why timeliness goals are not always met and by ensuring

¹ Internal Revenue Code Section 501(c)(3) (2006).



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that all employees clearly understand what should be included in the Initiative. These actions should increase the likelihood that tax-exempt organizations will stop the prohibited activities before the relevant election and that tax-exempt organization activities will be evaluated consistently and fairly.

Synopsis

The TE/GE Division effectively focused on prohibited political campaign intervention by emphasizing efforts to educate tax-exempt organizations about prohibited political activities, improving internal processes, and setting up a program to detect tax-exempt organizations that are potentially involved in repeated campaign intervention. For example, the Division published a “Fact Sheet” in February 2006 with detailed examples of the types of activities the IRS investigated during the 2004 election cycle, along with related commentary to help tax-exempt organizations better understand what activities constitute political intervention. The EO function also improved the 2006 Initiative by more clearly defining timeliness guidelines and procedures for evaluating and assigning referrals for examination.

While the EO function created more detailed timeliness standards for evaluating referrals, the TE/GE Division did not always meet the timeliness standards. As a result, tax-exempt organizations might not be notified prior to the relevant election, thereby providing less assurance that prohibited political activities will cease prior to the relevant election. The EO function tracks the amount of time required to process a referral that warrants examination for potentially prohibited activity from the date it is received to the date first contact is made with the tax-exempt organization advising it that it might be involved in a prohibited political activity. However, the amount of time taken to perform each individual activity was not always tracked, which limits EO function management’s ability to pinpoint the source of processing delays.

In addition, employees within the EO function did not always understand why certain referrals were not included in the Initiative. Employees responsible for initially identifying and researching referrals with alleged political intervention identified 12 referrals (in addition to the 100 referrals selected for the 2006 Initiative) that were not included in the Initiative, despite having issues similar to referrals that were included in the Initiative. However, upon reviewing the information, the Referral Committee responsible for fairly and impartially considering whether referrals have examination potential decided that the referrals did not meet the criteria for the Initiative. We believe that it is appropriate for an experienced, independent Referral Committee to reject referrals for the Initiative under certain circumstances, and we understand that criteria cannot be written to address every situation. However, we also believe that due to the sensitivity of the referrals involving potentially prohibited political activities, all employees must clearly understand what should be included in the Initiative.



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Recommendations

We recommended that the Director, EO, ensure that all referrals of potentially prohibited political intervention are reviewed in a timely manner. To ensure the success of the Initiative, all significant activities should be tracked to ensure that adequate staffing is available to meet the EO function's established timeliness goals. In addition, we recommended that the Director, EO, seek to improve the consistent understanding of prohibited political intervention criteria within the EO function.

Response

The Commissioner, TE/GE Division, agreed with our findings with respect to these issues and has completed several corrective actions to address the recommendations in our report. These actions include 1) continuing to monitor established timeliness goals in the 2008 Initiative, 2) modifying the timeliness goals to accommodate a new electronic case processing system, 3) continuing the policy requiring the Referral Committee to review political activity referrals on an as-required basis, 4) starting the 2008 Initiative earlier than the 2006 Initiative to reduce backlog, 5) reminding all personnel of the importance of the expedited time periods, and 6) training 30 additional agents on the Initiative to increase the TE/GE Division's ability to handle caseload in a timely manner. In addition, Division management ensured that all employees involved in the 2008 Initiative received the same training on political campaign intervention by Internal Revenue Code Section 501(c)(3) organizations and instituted a process for the Referral Committee to provide feedback to the EO Classification function staff concerning why a referral was not selected for the Initiative.

The Commissioner, TE/GE Division, also provided perspective on how the Division processes referrals of potentially prohibited political activities by tax-exempt organizations. Management's complete response to the draft report is included as Appendix IV.

Office of Audit Comment

The Commissioner, TE/GE Division, provided alternate corrective actions for our recommendation to ensure that all referrals of potentially prohibited political intervention are reviewed in a timely manner. Actions such as training additional personnel to handle the caseload and starting the Initiative earlier in the year could help the IRS to better meet its timeliness goals. We agree with the alternate corrective actions and suggest that Division management continue to monitor timeliness goals and take additional actions if referrals are not processed in a timely manner.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or



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Nancy A. Nakamura, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.



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Improvements Have Been Made to Educate Tax-Exempt Organizations and Enforce the Prohibition Against Political Activities, but Further Improvements Are Possible

Abbreviations

EO	Exempt Organizations
IRS	Internal Revenue Service
TE/GE	Tax Exempt and Government Entities



Improvements Have Been Made to Educate Tax-Exempt Organizations and Enforce the Prohibition Against Political Activities, but Further Improvements Are Possible

Background

Organizations that are exempt from Federal income taxes under Internal Revenue Code Section 501(c)(3)¹ are prohibited from directly or indirectly participating or intervening in any political campaign on behalf of, or in opposition to, any candidate for public office. The prohibition applies to campaigns at the Federal, State, and local levels. Charities, educational institutions, and religious organizations, including churches, are covered by this prohibition.

As a result, these organizations are prohibited from endorsing candidates, making campaign donations, engaging in fundraising, distributing statements, or becoming involved in any other activities that may be beneficial or detrimental to any particular candidate. For example, allowing a candidate to use an organization's assets or facilities would violate the prohibition if other candidates are not given the same opportunity to use the organization's assets or facilities. Activities that encourage people to vote for or against a particular candidate on the basis of partisan criteria are also prohibited.

Referrals concerning potentially prohibited activities are received in the Exempt Organizations (EO) Classification function, where employees research the issue presented in each referral by gathering supporting evidence. This evidence is then provided to an independent, experienced group of EO function employees, known as the Referral Committee.² The Committee considers the referral and supporting evidence and decides whether the referral warrants an examination. Referrals that the Committee determines warrant examination are forwarded to an EO Examination function group that notifies the tax-exempt organization that it will be investigated for potentially prohibited political activity.

The prohibition against political activities for charities and churches has existed since the 1954 revision of the Internal Revenue Code. However, in the 2004 election cycle, the Internal Revenue Service (IRS) recognized that referrals of potential political intervention by charities and churches were increasing. In response, the IRS initiated a Political Activities Compliance Initiative (the Initiative) in June 2004. The Initiative expanded on the IRS' prior educational efforts to remind tax-exempt organizations about the prohibition against political activities and the consequences of violating the prohibition. The IRS also enhanced its enforcement program to move quickly on specific, credible referrals of prohibited activities by expediting the processing of referrals to more quickly notify tax-exempt organizations when the IRS was

¹ Internal Revenue Code Section 501(c)(3) (2006).

² The Referral Committee is comprised of three members who are experienced EO function technical employees (e.g., senior examiners, function specialists, group managers, or area managers). The Committee's responsibility is to fairly and impartially consider whether information items referred have examination potential.



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reviewing potentially prohibited political activities. The enforcement program will also determine:

- Whether the organization participated in prohibited political activities.
- The remedies for organizations that are determined to have participated in prohibited political activities. Remedies could include revocation of tax-exempt status.

In November 2004, we commenced a review of the Initiative at the requests of the IRS Commissioner and the Commissioner, Tax Exempt and Government Entities (TE/GE) Division. The audit was limited to an assessment of the process for reviewing referrals and did not assess the results of examinations or determine whether the activities by the tax-exempt organizations involved potentially prohibited political activity. We reported in February 2005 that the TE/GE Division handled referrals of potential political campaign intervention consistently, but the referrals were not always processed in a timely manner.³

After the completion of our previous audit, the EO Examination function continued to work the examinations of potentially prohibited political activity as part of the 2004 Initiative. As shown in Figure 1, IRS results from the 2004 Initiative substantiated that tax-exempt organizations were engaging in prohibited political activity.

Figure 1: Results of 2004 Initiative

IRS Examination Results	Action Taken by the IRS	Number of Cases	Percentage of Cases
Prohibited Political Activities Identified	Written Advisory Sent to Tax-Exempt Organization	71	65%
	Tax-Exempt Status Revoked	5	5%
No Prohibited Political Activities Identified	Closing Letter Issued to Tax-Exempt Organization	29	26%
Pending	Pending	5	5%
Total Examination Cases		110	100%

Source: IRS political activity campaign database as of January 25, 2008.⁴

³ Review of the Exempt Organizations Function Process for Reviewing Alleged Political Campaign Intervention by Tax Exempt Organizations (Reference Number 2005-10-035, dated February 2005).

⁴ We did not verify the information provided by the EO function. Percentages might not add up to 100 percent due to rounding.



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Because a high number of the organizations examined in the 2004 Initiative were found to have engaged in prohibited political activity, the TE/GE Division enhanced the process to expedite the processing of potentially prohibited political activity referrals for the 2006 election cycle in an attempt to stop prohibited activities before the relevant election. In addition, Division management anticipates a vigorous 2008 election cycle and has pledged in media reports to follow up on all referrals judged worthy of pursuit.

This review was performed at the National Headquarters of the TE/GE Division in Washington, D.C.; the EO Examination function in Dallas, Texas; and the EO Examination field office in Independence, Ohio, during the period July 2007 through January 2008. Similar to our previous audit, we did not assess the results of examinations or determine whether the activities by the tax-exempt organizations involved potentially prohibited political activity.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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Results of Review

The TE/GE Division effectively focused on prohibited political campaign intervention by emphasizing efforts to educate tax-exempt organizations about prohibited political activities, improving internal processes, and setting up a program to detect tax-exempt organizations that are potentially involved in repeated campaign intervention. While educational efforts and streamlined processes enabled the IRS to make substantial improvements to the Initiative, the IRS could make further enhancements by having data readily available to pinpoint the reasons why timeliness goals are not always met and by ensuring that all employees clearly understand what should be included in the Initiative.

Educational Activities Were Enhanced and Procedures Were Improved

The TE/GE Division has enhanced its efforts to educate tax-exempt organizations (specifically charities and churches) about prohibited political activities, including the enforcement consequences of engaging in these types of activities. The Division effectively accomplished this since our last report in February 2005 by completing the following activities:⁵

- Publishing the results of the 2004 Initiative in February 2006. Because the 2004 election cycle involved the EO function's first formal Initiative to address prohibited political activity, this was the first time the public had been provided with a detailed report including specific instances of alleged and confirmed political intervention, lessons learned from performing the examinations, the methodology for selecting the cases for the Initiative, and planned actions for the Initiative to move forward. The results revealed that approximately 70 percent of tax-exempt organizations examined in the 2004 Initiative engaged in some level of prohibited political activity.
- Publishing a "Fact Sheet" in February 2006. While the IRS has issued Fact Sheets in the past concerning prohibited political activities, this Fact Sheet included detailed examples of the types of activities the IRS investigated during the 2004 election cycle, along with related commentary to help tax-exempt organizations better understand what activities constitute political intervention. The document also reflected the IRS' interpretation of tax laws enacted by Congress, as well as Department of the Treasury regulations and court decisions.

⁵ *Review of the Exempt Organizations Function Process for Reviewing Alleged Political Campaign Intervention by Tax Exempt Organizations* (Reference Number 2005-10-035, dated February 2005).



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- Publishing another Fact Sheet in February 2008 to provide an explanation of the IRS referral process for complaints alleging abuse of an organization's tax-exempt status, including complaints alleging prohibited political activities. When reviewing referrals, the IRS follows special procedures to assure the public of its objectivity in the treatment of tax-exempt organizations.
- Publishing a new Revenue Ruling in June 2007. While the IRS has previously issued revenue rulings concerning prohibited political activities, this Ruling enhanced education efforts by providing 21 examples that illustrate the application of the facts and circumstances to be considered when determining whether a tax-exempt organization participated or intervened in any political campaign.
- Increasing the frequency of press releases, newsletters, and educational efforts covering prohibited political activities by tax-exempt organizations to reach out to tax-exempt organizations that might be unaware of the prohibition. Included in this effort were nine newsletters distributed since the issuance of our last report on the 2004 Initiative, several workshops focusing on small to mid-size tax-exempt organizations, and presentations at six IRS tax forums in both Calendar Years 2006 and 2007.
- Sponsoring a video program for the first time on the IRS web site that included IRS subject-matter experts explaining the political campaign intervention rules that apply to tax-exempt organizations. In addition, the IRS initiated a telephone forum to answer questions regarding the prohibition against political campaign activity by tax-exempt organizations.
- Updating a webpage on the IRS web site specific to political campaign intervention. With the increased focus on educational activities, this webpage provides one place where taxpayers and tax-exempt organizations can obtain press releases, revenue rulings, tax law, Initiative reports for 2004 and 2006, and other educational postings.
- Anticipating the potential for an increase in prohibited political activities by starting the Initiative earlier in the election year. For example, the EO function started the 2006 Initiative in March, which was 3 months earlier than the 2004 Initiative. In anticipation of the potential for an increase in activities as a result of the presidential election, the 2008 Initiative was moved up even further to January 1, 2008.

Educating tax-exempt organizations about political activity prohibitions is a priority for the EO function.

The EO function also improved the 2006 Initiative by more clearly defining timeliness guidelines and procedures for evaluating and assigning referrals for examination. Employees assigned to evaluate referrals follow specific timeliness goals that were created to enable the TE/GE Division to quickly initiate contact with the tax-exempt organization advising it that it might be involved in prohibited political activity. Other process improvements included:



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- Conducting training in December 2005 on political activity issues for most employees involved in the processing of referrals to educate employees about specific issues surrounding the prohibition against political activities.
- Prioritizing referrals based on the complexity of the issue, as well as the type of tax-exempt organization being investigated, to provide better assurance that referrals are routed to employees best qualified to handle the issue.
- Increasing the priority of working political activity referrals in relation to other work performed within the EO Examination function.
- Improving information used to manage the Initiative. After the 2004 election cycle, the EO function gathered information on the results of the Initiative. During the 2006 Initiative, an analyst was assigned to continually track the status of the referrals, compile statistical data on the results of the referrals examined in the Initiative, and report the results on the types of referrals and violations identified.
- Establishing a process to identify potential repeat offenders from prior election cycles. 1
- Initiating a sub-project to identify and investigate prohibited contributions by tax-exempt organizations to candidates for public office.

Improving Selected Processes Could Assist in Meeting Timeliness Goals and Improve the Understanding of Referral Criteria

The EO function increased its efforts to educate tax-exempt organizations about prohibited political activities and improved some internal processes. However, additional improvements can be made to ensure that tax-exempt organizations receive timely notification that they might be involved in prohibited political activity. Also, the EO function needs to clarify why certain referrals are not included in the Initiative. These actions should increase the likelihood that tax-exempt organizations will stop the prohibited activities before the relevant election and that tax-exempt organization activities will be evaluated consistently and fairly.



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Improving data collected on timeliness could help the EO function meet its timeliness goals

The EO function created more detailed timeliness standards for evaluating referrals (e.g., it set specific timeliness goals for EO Classification function employees to process referrals and for EO Examination function employees to establish contact with tax-exempt organizations). However, it did not always meet the timeliness standards. As a result, tax-exempt organizations might not be notified prior to the relevant election, thereby providing less assurance that prohibited political activities will cease prior to the relevant election.

Referrals were not always researched in a timely manner and evaluated for examination potential by employees in the EO Classification function. In addition, referrals were not directed in a timely manner to employees responsible for contacting the organization and conducting the examination in the EO Examination function groups. Overall, 63 of the 100 referrals selected for examination in the 2006 Initiative were not processed in a timely manner using the established expedited process. As noted in Figure 2, about 20 percent of the cases missed the IRS' expedited timeliness goals by more than 30 calendar days.

Referrals were not always reviewed in a timely manner for examination potential.

Figure 2: Referral Processing Time for the 2006 Initiative

	Referrals Reviewed	Referrals That Missed the Expedited Timeliness Goals	Timeliness Goals Missed by Fewer Than 16 Calendar Days	Timeliness Goals Missed by Between 16 and 30 Calendar Days	Timeliness Goals Missed by More Than 30 Calendar Days
Referrals Involving Churches	43	30	7	8	15
Referrals Involving Charities	57	33	19	8	6
Total Initiative Referrals	100	63	26	16	21

Source: Analysis of the EO function's timeliness reports for the 2006 Initiative.⁷

The EO function tracks the amount of time required to process a referral that warrants examination for potentially prohibited activity from the date it is received in the

⁷ We did not verify the accuracy of this information.



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EO Classification function to the date first contact is made with the tax-exempt organization advising it that it might be involved in a prohibited political activity. The amount of time taken by the various segments of the EO function, such as Classification, EO Counsel (for church referrals), and the Examination groups, is also separately tracked.

However, the amount of time taken to perform each individual activity within the EO Classification function was not always tracked, which limits EO function management's ability to pinpoint the source of processing delays. In addition, the EO function has not set specific timeliness goals for each activity in the Classification function. Individually tracking the amount of time it takes to 1) research and build a case for the Referral Committee to review, 2) determine if an examination is warranted, and 3) assign a referral to an EO Examination function group would enable EO function management to better identify and remedy bottlenecks in the processing of referrals.

After the 2006 election cycle, the EO function analyzed the referrals to assess delays by reviewing referrals involving churches included in the 2006 Initiative and concluded that the referrals generally did not meet processing time standards due to backlogs in the EO Classification and Examination functions. The primary reasons for the delays included 1) having insufficient staff to work referrals in the Classification function due to scheduled vacation time and 2) the EO function not always applying the time standards for expediting Initiative referrals because some Examination groups had become saturated with cases identified from the referrals.

The Director, EO, advised us that the decision to not track individual activities was purposeful so that the EO Classification function would have greater flexibility for prioritizing the work. However, having additional data to determine where bottlenecks might be occurring would provide the EO function with information needed to adapt to increasing receipts by ensuring that appropriate staffing is available to meet established timeliness goals.

Improving communication among different employees involved in processing referrals would increase understanding of referral criteria

While the EO function enhanced its efforts to educate tax-exempt organizations about prohibited political activities by providing examples of prohibited activities and through other educational activities, employees within the EO function did not always understand why certain referrals were not included in the Initiative. Employees responsible for initially identifying and researching referrals of alleged political intervention identified 12 referrals (in addition to the 100 referrals selected for the 2006 Initiative) that were not included in the Initiative, despite having issues similar to referrals that were included in the Initiative. Upon reviewing the information, the Referral Committee decided the referrals did not meet the criteria for the Initiative. However, the Referral Committee determined that the referrals needed to be examined and used its discretion to

Criteria used to evaluate referrals were interpreted differently among employees within the EO function.



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forward the referrals for examination outside of the Initiative. Examinations conducted outside the Initiative are not subject to expedited time standards and are not given priority over non-Initiative cases. In addition, examiners may use their discretion to close non-Initiative cases without conducting the examination due to other priority work.

We reviewed copies of the 12 referral files and concluded that there were indications of prohibited political activity,⁸ but we did not make a determination as to whether the referrals should have been included in the Initiative. We believe that it is appropriate for an experienced, independent Referral Committee to reject referrals for inclusion in the Initiative under certain circumstances, and we understand that criteria cannot be written to address every situation. However, we also believe that sound management practices dictate that due to the sensitivity of the referrals involving potentially prohibited political activities, all employees must be aware of and clearly understand criteria for determining what referrals should be included in the Initiative.

One reason this might have occurred is that not all employees received the specialized training for the 2006 Initiative. In addition, EO function employees who provide cases to the Referral Committee might not receive adequate feedback in the case file when a case is rejected for the Initiative. Providing the same training to all employees involved in the Initiative and ensuring adequate feedback from the Committee as to why a referral is not selected would clarify what constitutes prohibited political activity and provide better assurance that all organizations potentially involved in prohibited political activities are being treated consistently and fairly.

Recommendations

The Director, EO, should:

Recommendation 1: Ensure that all referrals of potentially prohibited political activities are evaluated in a timely manner by:

- Tracking the timeliness of all significant activities associated with the processing of referrals.
- Analyzing collected data to ensure that appropriate staffing is available to meet established timeliness goals.

Management's Response: TE/GE Division management agreed with the finding, and they have completed several corrective actions to address this recommendation. The Division analyzed the timeliness data in the 2006 Initiative to determine whether the timeliness goals should be modified but believed that any further sub-division of these goals, particularly in the Classification stage, would impede its flexibility in meeting

⁸ We determined that there were indications of potentially prohibited political activities by comparing the referrals to the 2006 Fact Sheet, applicable revenue rulings, EO function Initiative training documents, and EO function educational materials.



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these goals. Division management plans to maintain the same goals as those employed in the 2006 Initiative, with one modification as noted in the first bullet below. The Division will, however, continue to monitor its timeliness goals in the 2008 Initiative. Management has taken the following actions to improve the Division's ability to meet the timeliness goals:

- Modified the timeliness goals by adding 2 days for a group manager to assign a case to an agent, to accommodate the new electronic case processing system.
- Required the Referral Committee to continue meeting on an as-required basis to review referrals concerning political campaign intervention during the period between the 2006 and 2008 cycles.
- Started the 2008 Initiative earlier than the 2006 Initiative to reduce backlog.
- Reminded all personnel about the importance of the expedited time periods via email and in monthly conference calls.
- Trained an additional 30 agents on the Initiative to increase the Division's ability to handle its caseload in a timely fashion.

Office of Audit Comment: The Commissioner, TE/GE Division, provided alternate corrective actions for our recommendation to ensure that all referrals of potentially prohibited political intervention are reviewed in a timely manner. Actions such as training additional personnel to handle the caseload and starting the Initiative earlier in the year could help the IRS to better meet its timeliness goals. We agree with the alternate corrective actions and suggest that Division management continue to monitor timeliness goals and take additional actions if referrals are not processed in a timely manner.

Recommendation 2: Seek to improve the consistent understanding of prohibited political intervention criteria within the EO function by ensuring that:

- All employees involved in the Initiative receive the same training.
- Adequate feedback is provided by the Referral Committee to those who research the referrals when the Committee rejects cases for the Initiative.

Management's Response: TE/GE Division management agreed with this recommendation and has implemented corrective actions. All employees involved in the 2008 Initiative, including the members of the Referral Committee, received the same training on political campaign intervention by Internal Revenue Code Section 501(c)(3) organizations. In addition, Division management instituted a process for the Referral Committee to provide feedback to the EO Classification function staff concerning why a referral was not selected for the Initiative.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to assess the effectiveness of the TE/GE Division in addressing alleged political campaign intervention by Internal Revenue Code Section 501(c)(3)¹ organizations and to determine whether actions to date had detected potential repeated campaign intervention by previously identified organizations. To accomplish this objective, we:

- I. Reviewed actions taken by TE/GE Division management since our February 2005 report² to educate Section 501(c)(3) organizations about their responsibilities related to political activities.
 - A. Interviewed EO function management to determine whether any education and outreach efforts were taken related to political activity.
 - B. Obtained any press releases, letters, or other correspondence/documentation issued by the TE/GE Division to assess the adequacy of management's corrective actions to recommendations made in our prior report.
 - C. Interviewed EO function management to determine current plans for the 2008 election year and whether any changes in the process will be made based on the results of the Political Activities Compliance Initiative (the Initiative).
- II. Evaluated the process established by TE/GE Division management during the 2006 election year for reviewing referrals of political campaign intervention, addressing any noncompliance identified in the area, and capturing accurate and complete results for the Initiative.
 - A. Interviewed Division management to determine the process established to review referrals of political campaign intervention during the 2006 election year.
 - B. Obtained any procedures or documentation related to the revamping of the existing process for receiving and reviewing referrals of political campaign intervention to assess the adequacy of management's corrective actions to recommendations made in our prior report.

¹ Internal Revenue Code Section 501(c)(3) (2006).

² *Review of the Exempt Organizations Function Process for Reviewing Alleged Political Campaign Intervention by Tax Exempt Organizations* (Reference Number 2005-10-035, dated February 2005).



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- C. Evaluated processes for capturing Initiative results and assessed whether all referrals were included in the Initiative's results.
- D. Reviewed cases identified as potentially not being captured in the Initiative and assessed whether they contained indications of prohibited political activity.
- III. Assessed actions taken to address the untimeliness of processing referrals reported in the 2006 Initiative results.
- IV. Determined whether EO function actions to date have detected repeat potential political campaign intervention by Section 501(c)(3) organizations.
 - A. Interviewed EO function management to determine actions taken since the issuance of our prior report to identify repeat allegations of political intervention by Section 501(c)(3) organizations.
 - B. Obtained any procedures or documentation related to identifying and addressing repeat allegations of political campaign intervention by Section 501(c)(3) organizations.
 - C. Reviewed the results of any actions taken since the issuance of our prior report to determine whether any repeat allegations of political campaign intervention have been identified and addressed.

Data validation methodology

We obtained an extract of the EO function's referral database. Validations performed included ensuring that only appropriate data were included in each field and that the time period for the data met our requirements. We determined that the data were sufficiently reliable for our use.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our objective: the EO function's policies, procedures, and practices for planning, managing, and monitoring the Initiative. We evaluated these controls by interviewing management, reviewing applicable information, and analyzing referrals with potential political activity.



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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Tax Exempt and Government Entities Division SE:T
Director, Exempt Organizations, Tax Exempt and Government Entities Division SE:T:EO
Chief Counsel CC
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Audit Liaison: Director, Communications and Liaison, Tax Exempt and Government Entities Division SE:T:CL



Improvements Have Been Made to Educate Tax-Exempt Organizations and Enforce the Prohibition Against Political Activities, but Further Improvements Are Possible

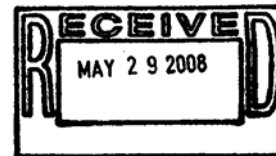
Appendix IV

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

MAY 29 2008



MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Steven T. Miller *Steven T. Miller* POK
Commissioner, Tax Exempt and Government Entities

SUBJECT: Response to Draft Audit Report – Improvements Have
Been Made to Educate Tax-Exempt Organizations and
Enforce the Prohibition Against Political Activities, but
Further Improvements Are Possible (Audit #200710036)

This responds to your draft audit report ("report") concerning the effectiveness of the Exempt Organizations ("EO") function of the Tax Exempt and Government Entities Division ("TEGE") in addressing alleged political campaign intervention by Internal Revenue Code Section 501(c)(3) organizations and whether EO detected potential repeated campaign intervention during the 2006 election cycle by organizations previously identified as having engaged in campaign intervention. Your review was prompted by a request from the former Commissioner of Internal Revenue.

Your report notes that our educational efforts and improved internal processes have resulted in substantial improvements in the PACI program. You also suggest several additional improvements to better meet our timeliness goals and to provide training to EO employees involved in the PACI program. We agree with TIGTA's findings with respect to these issues and have already completed corrective actions to address the recommendations in your report. As noted in the attachment, we have taken a number of steps to achieve our timeliness goals in the 2008 PACI program and have provided training to all EO employees involved in it.

I wish to comment briefly on your discussion of the 12 referrals that the PACI Referral Committee did not select for the PACI program, but did forward for examination under the general program. The report accurately notes that "[e]xaminations conducted outside the Initiative are not subject to expedited time standards and are not given priority over non-Initiative cases." With respect to the 12 referrals, the PACI Referral Committee, in the exercise of its responsibility, determined that they did not merit examination on the issue of political campaign intervention by a section 501(c)(3) organization. The committee found, however,



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that they did merit examination on some other issue. Because these cases were ultimately referred to Examination for issues *other* than political campaign intervention by a section 501(c)(3) organization, it is appropriate that they were not processed in accordance with the expedited time standards and priority of PACI.

The report also discusses the need for the Referral Committee to provide feedback to Classification staff as to why a referral was not selected for examination. Classification staff does not make recommendations on whether or not a referral warrants examination under the PACI procedures. Our procedures call for them to forward *all* allegations of political campaign intervention to the Referral Committee. It is then the responsibility of the Referral Committee to determine whether the allegation has sufficient merit for further action. The independence of the Referral Committee is the core of the PACI system's integrity. Nevertheless, in our continuing efforts to educate staff on these issues, we have instituted a process for the Referral Committee to provide feedback to Classification staff concerning why a referral was not selected for examination.

Our response to your recommendations appears on the attachment.

Attachment



Improvements Have Been Made to Educate Tax-Exempt Organizations and Enforce the Prohibition Against Political Activities, but Further Improvements Are Possible

Attachment

Recommendation 1

Ensure that all referrals of potentially prohibited political activities are evaluated in a timely manner by:

- Tracking the timeliness of all significant activities associated with the processing of referrals.
- Analyzing collected data to ensure appropriate staffing is available to meet established timeliness goals.

Corrective Action

We agree with this finding but have implemented a corrective action different from the one recommended by TIGTA. We have analyzed the data concerning timeliness in the 2006 PACI cycle. We believe that any further sub-division of the timeliness goals, particularly in the Classification stage, would impede our flexibility in meeting these goals. We therefore do not plan to further sub-divide these goals. Nonetheless, we will continue to monitor our timeliness goals in the 2008 PACI cycle and have taken the following actions to improve our ability to meet the timeliness goals:

- We reviewed the timeliness goals to determine whether they should be modified. While generally maintaining the same goals as those we employed in the 2006 cycle, we have increased by 2 days the time for a group manager to assign a case to an agent. We have done this to accommodate our new electronic case processing system.
- We required the PACI Referral Committee to continue meeting on an as-required basis to review referrals concerning political campaign intervention during the period between the 2006 and 2008 PACI cycles, and we started the 2008 PACI cycle earlier than the 2006 PACI cycle to reduce backlog.
- We reminded all personnel about the importance of the expedited time frames via email and in monthly conference calls.
- We trained an additional 30 PACI agents to increase our ability to handle caseload in a timely fashion.

Implementation Date

Completed.

Responsible Official

Director, EO Examination



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Recommendation 2

Seek to improve the consistent understanding of prohibited political intervention criteria within the EO function by ensuring that:

- All employees involved in the Initiative receive the same training.
- Adequate feedback is provided by the Referral Committee to those who research the referrals and the referral database is updated when the Referral Committee rejects cases for the Initiative.

Corrective Action

We agree with this recommendation and have implemented the following corrective actions. All employees involved in the 2008 PACI, including the members of the Referral Committee, have received the same training on political campaign intervention by section 501(c)(3) organizations. We have instituted a process for the Referral Committee to provide feedback to Classification staff concerning why a referral was not selected for the PACI program.

Implementation Date

Completed.

Responsible Official

Director, EO Examination